

EXHIBIT 18

Committee on Natural Resources

Rob Bishop Chairman
Hearing Memorandum

July 23, 2018

To: Members of the Committee on Natural Resources

From: Majority Committee Staff, Andrew Vecera (x59297)

Hearing: Oversight Hearing entitled "*Management Crisis at the Puerto Rico Electric Power Authority and Implications for Recovery*"
July 25, 2018 at 2:00 P.M.; 1324 Longworth House Office Building

The Committee will hold a hearing on **July 25, 2018, at 2:00 P.M. in 1324 Longworth House Office Building**, addressing the need for legislation to resolve the ongoing mismanagement and disarray of the Puerto Rico Electric Power Authority.

Policy Overview

- Puerto Rico's near and long-term recovery is dependent on a functional and reliable electric system. The island's energy utility, the Puerto Rico Electric Power Authority (PREPA), faces systemic and intractable political and management failures.
- Much of PREPA's future depends on the leadership and commitment of the Government of Puerto Rico; and unfortunately, the current government continues to inject political calculations into the management scheme of PREPA. Unless the leadership of PREPA can be divorced from the politics of Puerto Rico, PREPA will continue to be a dysfunctional utility.
- Although the enabling statute for the Puerto Rico Energy Commission deemed it an independent regulator, the Commission is still subject to outside pressures including recent legislative interference, limiting its authority to protect ratepayers and ensure the orderly transformation of PREPA into a functional utility.
- The Federal Oversight and Management Board's decision to reject the consensually negotiated Restructuring Support Agreement for PREPA subjected the utility to a future of litigation, and a limitation on what reforms will be achievable. Without a means effecting a consensual resolution of the debt and other legacy obligations including pensions, the Title III case will be a protracted legal struggle which will hinder PREPA's transformation.
- Privatization should be the end goal that will achieve a successful conversion of PREPA; however, substantive structural and cultural reform within PREPA must occur first.

Invited Witnesses (in alphabetical order)

Eduardo Bhatia

Minority Leader, Senate of Puerto Rico
San Juan, PR

Thomas Emmons

Partner, Pegasus Capital Advisors
New York, NY

The Honorable Ricardo Rosselló

Governor of Puerto Rico
San Juan, PR

James Spiotto

Managing Director, Chapman Strategic Advisors LLC
Chicago, IL

David Svanda

Principal, Svanda Consulting
Clarksville, MD

The Honorable Bruce Walker

Assistant Secretary, Office of Electricity
Department of Energy
Washington, D.C.

Background

The Puerto Rico Electric Power Authority (PREPA) has operated as the electric utility for Puerto Rico since 1941 with statutory authority to “determine, fix, alter, change and collect reasonable rates, fees, rentals and other charges for the use of installations . . . or for electric power services.”¹ This broad grant of monopolistic power without a corresponding regulatory authority allowed PREPA to operate as an unaccountable entity, governed by dozens of political patronage jobs.² As a result, PREPA spiraled into mismanagement, accumulating \$9 billion of debt and foregoing critical maintenance of its electrical infrastructure.³ Despite legislative attempts by Puerto Rico to meet the debt crisis and employ an independent regulatory body, PREPA continued to languish.⁴

¹ Puerto Rico Act 83-1941, at § 6(1).

² See “The story of Puerto Rico’s power grid is the story of Puerto Rico,” *The Economist*, Oct. 19, 2017, available at <https://www.economist.com/united-states/2017/10/19/the-story-of-puerto-ricos-power-grid-is-the-story-of-puerto-rico>.

³ *Id.*

⁴ See Puerto Rico Act 57-2014 and Puerto Rico Act 4-2016.

In response to PREPA's – and the Commonwealth's – debt crisis, the House Committee on Natural Resources (Committee) forwarded the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA),⁵ which sought to “provide a method for [Puerto Rico] to achieve fiscal responsibility and access to the capital markets.”⁶ PROMESA established a Financial Oversight and Management Board (FOMB) tasked with overseeing the consensual negotiation of outstanding debt, the adoption of procedures to ensure timely audited financial statements, and the development of fiscal plans, which serve as broad structural documents effecting the necessary changes to ensure the achievement of PROMESA's purpose.⁷

During the development of PROMESA, bondholders of PREPA's debt successfully negotiated a restructuring support agreement (RSA) with then Chief Restructuring Officer of PREPA, Lisa Donahue. The RSA alleviated PREPA's debt burden through four key measures: (i) the refinancing of PREPA's debt on consensual terms (including a five-year window of reduced debt service obligations); (ii) the restoration of PREPA's financial stability through debt reduction of approximately \$1.1 billion; (iii) the reinvestment in PREPA's aging power generation platform; and (iv) the “provi[sion of] reliable and cost-effective energy to the people of Puerto Rico.”⁸

The formulation of the RSA was critical to the passage of PROMESA, as it exemplified the consensual renegotiation of debt PROMESA encouraged, while resolving the largest hurdle preventing Puerto Rico's economic recovery – the broken electric utility. Thus, the Committee included within PROMESA a provision deeming “preexisting voluntary agreements,” such as PREPA's RSA, to conform with the objectives of restructuring agreements under PROMESA.⁹ Despite this statutory mandate, the FOMB rejected the RSA, on June 27, 2017, reinstating the political turmoil that had governed PREPA for decades and further delaying PREPA's access to needed liquidity for maintenance of its dated infrastructure.¹⁰ Although Gov. Rosselló had continually embraced the RSA, provided that specific modifications were adopted, his administration did not rebuke the FOMB's veto of the negotiated deal.¹¹

Tragically, the dire conditions of Puerto Rico's electric grid would be highlighted three months after the FOMB's decision on the RSA, as Puerto Rico experienced its most devastating hurricane season on record.¹² Both hurricanes Irma and Maria left the entire island without a functioning electric grid and resulted in the loss of life for hundreds of American citizens.

⁵ 48 U.S.C. § 2101 *et seq.*

⁶ 48 U.S.C. § 2121(a).

⁷ See 48 U.S.C. § 2146 and 2141(b)(1).

⁸ See “PREPA RSA Contemplates Consensual Financial Debt Restructuring with Bondholders Under the Provision of Title VI of PROMESA,” May 8, 2017, available at <https://www2.aeepr.com/noticias/noticiasread.asp?r=MKHEUBZISE>.

⁹ See 48 U.S.C. § 2124(i)(3).

¹⁰ Financial Oversight and Management Board for Puerto Rico, “Oversight Board does not Approve PREPA's RSA,” June 27, 2017, available at <https://drive.google.com/file/d/1iAILHHLyZfm1QgCVmeVmYe4Rsnadh7h/view>.

¹¹ See *The Status of the Puerto Rico Electric Power Authority (PREPA) Restructuring Support Agreement: Hearing before the Subcomm. on Indian, Insular and Alaska Native Affairs of the H. Comm. on Natural Resources*, 115th Cong. (statement of Gov. Rosselló).

¹² See Umair Irfan, “9 months after Hurricane Maria, thousands of Puerto Ricans still don't have power,” Vox.com, June 20, 2018, available at <https://www.vox.com/energy-and-environment/2018/6/13/17413828/puerto-rico-blackout-power-grid-hurricane-maria>.

Although many of these deaths can be attributed to the direct impact of the storm itself, the loss of electric service played a significant contributing factor to the death total.¹³ Furthermore, the hurricanes reemphasized the ineptitude of PREPA with the failure to call for mutual aid from mainland electric utilities, and the execution of a \$300 million contract with an untested contractor for recovery operations.¹⁴

Since the end of the 2017 hurricane season, PREPA has endured five CEOs, the resignation of the majority of the governing board, a failed attempt by the FOMB to appoint a “chief transformation officer,” and ongoing litigation related to the Title III bankruptcy case.¹⁵ As such, the status quo reflects a deeply troubled utility, unable to answer simple questions such as “who is in charge of the grid?”¹⁶ And despite legislative attempts by the Puerto Rican legislature, and similar efforts by the FOMB to privatize the utility, there appears to be no end in sight to the hurdles facing PREPA’s turnaround. This hearing will discuss the need for a legislative solution to PREPA’s plight, centered on the following four concepts: 1) the depoliticization of PREPA; 2) the need for a strong, independent regulator; 3) the resolution to the legacy debt and pension funds; and 4) providing a pathway to privatization.

Politics Continues to Play an Overwhelming Role in PREPA’s Operations

Throughout its history, PREPA’s “management and other strategic decisions, including staffing and capital investment, were too often based on political or electoral considerations rather than best practices or business imperatives.”¹⁷ This resulted in incoherent long-term planning, with each incoming administration reversing the actions of the former.¹⁸

Although the current Governor, Ricardo Rosselló, has acknowledged the politicization of PREPA and the need for independence within the utility, political influence seemingly continues to reign.¹⁹ In March of this year, Governor Rosselló facilitated the appointment of Walt Higgins

¹³ Nicole Acevedo, “New Hurricane Maria death toll estimates spotlight data-reliability issues in Puerto Rico,” NBC News, May 31, 2018, available at <https://www.nbcnews.com/storyline/puerto-rico-crisis/new-hurricane-maria-death-toll-estimates-spotlight-data-reliability-issues-n878701>.

¹⁴ Gavin Blade, “PREPA forgoes mutual aid, opting for little-known contractor,” Utility Dive, Oct. 10, 2017, available at <https://www.utilitydive.com/news/prepa-forgoes-mutual-aid-opting-for-little-known-contractor/506920/>.

¹⁵ Gavin Blade, “Puerto Rico governor names new PREPA CEO, board members,” Utility Dive, July 19, 2018, available at <https://www.utilitydive.com/news/puerto-rico-governor-names-new-prepa-ceo-board-members/528152/>. Daniel Bases, “U.S. judge denies request for outsider to oversee Puerto Rico’s PREPA,” Nov. 13, 2017, available at <https://www.reuters.com/article/us-usa-puertorico-prepa/u-s-judge-denies-request-for-outsider-to-oversee-puerto-ricos-prepa-idUSKBN1DD2MR>.

¹⁶ *The Puerto Rico Electric Grid: Hearing Before the S. Comm on Energy and Natural Resources*, 115th Cong. (opening statement of Chairman Lisa Murkowski), available at https://www.energy.senate.gov/public/index.cfm/files/serve?File_id=DB627AD1-4930-43AC-BD23-2E00D0FF7980.

¹⁷ *Exploring Energy Challenges and Opportunities Facing Puerto Rico: Hearing Before the Subcomm. on Energy and Mineral Resources of the H. Comm. on Natural Resources*, 114th Cong. (statement of Lisa Donahue), available at http://democrats-naturalresources.house.gov/imo/media/doc/testimony_donahue.pdf.

¹⁸ *Id.*

¹⁹ See Dalissa Zeda Sanchez “U.S. executive appointed to head Puerto Rico power company,” Caribbean Business, Mar. 20, 2018, available at <http://caribbeanbusiness.com/u-s-executive-named-to-head-puerto-rico-power-company/>.

to serve as the first, independent CEO to run PREPA. Mr. Higgins was guaranteed a salary of \$450,000, with a bonus package if he achieved certain milestones during his tenure.²⁰ However, following a decision from Puerto Rico's justice secretary that his bonus would be illegal, Mr. Higgins was forced to resign.²¹ Following his resignation, the PREPA board nominated a fellow board member, Rafael Diaz-Granados, to fulfill the role, guaranteeing a salary of \$750,000.²² Despite this salary being similar to the amount the Puerto Rican government pays to consultants,²³ political outrage took hold, with Governor Rosselló calling for a decrease in the salary, or the resignation of the board members. In response, the majority of PREPA's governing board resigned stating "[w]e no longer believe that we have the support to perform the politically unpopular tasks necessary to drive the change from within PREPA" and emphasizing that "[w]hen the petty political interests of politicians are put ahead of the needs of the people, the process of transforming the Puerto Rican electricity sector is put at risk."²⁴

The events of the past month are the most recent signs of the utility's continued dysfunction and that "political forces . . . continue to control PREPA."²⁵ And with the Department of Energy recognizing that the future success of PREPA "ultimately depends on the leadership and commitment of the Government of Puerto Rico," the future looks very similar to the past – unless the leadership of PREPA can be divorced from the overwhelming politics of Puerto Rico.²⁶

The Fledgling Puerto Rico Energy Commission is Unable to Accomplish its Mission

The Puerto Rico Energy Commission (PREC) was established in 2014 as "an independent government entity in charge of regulating, overseeing, and ensuring compliance with the public policy on energy of the Commonwealth of Puerto Rico."²⁷ The PREC was also granted the authority to approve the electricity rates proposed by PREPA, and to "oversee[] PREPA and other power producers, promoting the diversification of . . . energy sources as well as the reduction of energy costs."²⁸

²⁰ Danica Coto, "CEO of Puerto Rico's bankrupt power company abruptly resigns," Washington Post, July 11, 2018, available at https://www.washingtonpost.com/business/ceo-of-puerto-ricos-bankrupt-power-company-abruptly-resigns/2018/07/11/575e71f0-8523-11e8-9e06-4db52ac42e05_story.html?noredirect=on&utm_term=.498355db8748.

²¹ Although Mr. Higgins's resignation letter indicated salary as the precipitating cause for his departure, other sources have indicated a "request to fire any officer in trust positions who may have links to Senate President, Thomas Rivera Schatz." Joanisabel Gonzalez, "Creditors ask for a trustee in PREPA," El Nuevo Dia, July 19, 2018, available at <https://www.elnuevodia.com/english/english/nota/creditorsaskforatrusteeinprepa-2436283/>.

²² Michelle Yaske, "Puerto Rico Bankrupt Utility is Leaderless after Pay Scandal," Bloomberg, July 12, 2018, available at <https://www.bloomberg.com/news/articles/2018-07-12/puerto-rico-erupts-at-750-000-pay-for-ceo-at-bankrupt-utility>.

²³ For instance, the Puerto Rico Industrial Development Company currently pays Manuel Ortiz's (who the New York Times deemed "Puerto Rico's go to guy in Washington") firm, VantageKnight, at least \$690,000 per year for "advertising" costs. See Oficina Del Contralor, Contract Numbers 2018-000018 and 2019-000018, available at <https://contratos.ocpr.gov.pr/frmSelCont.aspx>.

²⁴ July 12, 2018 Resignation Letter from PREPA's Governing Board to Gov. Ricardo Rosselló Nevares.

²⁵ *Id.*

²⁶ U.S. Department of Energy, "Energy Resilience Solutions for the Puerto Rico Grid", at 9, June 2018, available at https://www.energy.gov/sites/prod/files/2018/06/f53/DOE%20Report_Energy%20Resilience%20Solutions%20for%20the%20PR%20Grid%20Final%20June%202018.pdf.

²⁷ Puerto Rico Act 57-2014

²⁸ *Id.*

In 2016, the PREC completed its first rate case in accordance with the RSA. Since then, it has found itself undercut by both the current administration of Puerto Rico and the FOMB. For instance, despite the PREC being “financially self-sustainable as its income is derived from electric rates,” the PREC depends on the “Governor’s Office for procurement of external consultants, outside counsel and personnel” – essentially, the PREC’s budget has been held hostage by the Governor’s Office.²⁹ Furthermore, the Governor has sought to combine the PREC with other regulatory entities, potentially limiting the PREC’s ability to oversee PREPA.³⁰ Similarly, PREC alleges the FOMB has “ignor[ed] every [PREC] effort to cooperate in the adoption of a set of procedures that would allow for the [PREC] and FOMB to support each other’s work.”³¹ These adverse actions resulted in “unwarranted and unnecessary delay[s] in the implementation of measures to achieve financial and operational responsibility.”³²

Indicative of the political pressures faced by the PREC is the recent legislative modification to the PREC’s structure. Last month, under the “Puerto Rico Electric System Transformation Act,” the number of commissioners was expanded from three to five, allowing for the current Administration to exercise greater control over the PREC.³³ Although the immediate implications – be they adverse or positive – of this expansion are unclear, the legislative modification of the PREC’s structure highlights the fluidity of the regulatory structure governing PREPA’s rates.

As demonstrated, the “independent” regulator is still subject to outside pressures, limiting its authority to protect ratepayers and ensure the orderly transformation of PREPA into a functional utility.

Without a Comprehensive Solution to Addressing the Legacy Debt including Pensions, PREPA will Continue to be Burdened by Litigation

PREPA’s legacy debt of \$9.25 billion and outstanding pension obligations of approximately \$3.6 billion continue to act as substantial hurdles faced by the utility.³⁴ However, with the rejection of the RSA, the FOMB forced into bankruptcy proceedings both the holders of the debt and the beneficiaries of the pensions.³⁵ Advocates of this move believed it would allow for a reduction of the existing debt “to a sustainable level,” while opponents indicated it was

²⁹ *The Puerto Rico Electric Grid: Hearing Before the S. Comm on Energy and Natural Resources*, 115th Cong. (statement of José H. Román Morales PE), available at https://www.energy.senate.gov/public/index.cfm/files/serve?File_id=570A3AEE-BE1F-4451-A2F4-224B14645EEB.

³⁰ Robert Walton, “Puerto Rico Gov. Rossello proposes overhaul of energy regulator,” *Utility Dive*, Jan. 10, 2018, available at <https://www.utilitydive.com/news/puerto-rico-gov-rossello-proposes-overhaul-of-energy-regulator/514305/>.

³¹ *The Puerto Rico Electric Grid: Hearing Before the S. Comm on Energy and Natural Resources*, 115th Cong. (statement of José H. Román Morales PE).

³² *Id.*

³³ Puerto Rico House of Representatives House Bill no. 1481.

³⁴ Puerto Rico Electric Power Authority, New Fiscal Plan for PREPA: As Certified by the Financial Oversight and Management Board for Puerto Rico, April 19, 2018, available at <https://drive.google.com/file/d/1FgfYFjuuQTuH1nIQWY-xrEAWQxVdNPt/view>.

³⁵ See Federal Oversight and Management Board, Board Resolution Adopted on June 30, 2017, available at <https://drive.google.com/file/d/1kP3UIFK7FRwQBIPJ9Qf-VolkwgWsktJ8/view>.

“improper” “warn[ing] that it ‘would leave PREPA years away from attracting the private investment necessary to modernize.’”³⁶

The move to force PREPA into Title III bankruptcy proceedings, rather than adopting the RSA, has already cost an additional year of litigation, and millions of dollars in consultant fees. Further litigation has also been spawned, including a suit seeking to impose an independent receiver over PREPA.³⁷ As the Title III case proceeds, and the FOMB prepares and files a plan of adjustment to modify the debt, the closure of the Title III case will likely be prolonged by entities challenging whether the plan “is feasible and in the best interests of creditors, which shall require the court to consider whether available remedies under the non-bankruptcy laws and constitution of the territory would result in a greater recovery for the creditors than is provided by such plan.”³⁸ These challenges are anticipated, and will likely take years to resolve – limiting the effectiveness of the FOMB’s plan to privatize PREPA via the plan of adjustment.

As such, litigation looks to continue for the foreseeable future – and indeed, even the Fiscal Plan forwarded by the FOMB likely believes Title III closure to be sometime in 2019.³⁹ Without a means to affect a consensual resolution of the debt, the Title III case will hinder PREPA’s transformation into a functional utility.

PREPA Must be Systemically Transformed to Allow for a Pathway to Privatization

Act 57 recognized that “PREPA require[d] a thorough reform in its government, mission, and the manner in which it operates.”⁴⁰ Despite the recognition of these reforms, PREPA continues to be inundated with operational deficiencies that plague its operations and hinder its ability to adapt to the demands of an electric utility in an island environment like Puerto Rico.

PREPA has failed to properly collect from municipal accounts, as well as government instrumentalities, for decades. This municipal backlog alone reached \$750 million in 2016.⁴¹ PREPA’s failure to collect has also not pursued collection mechanisms for accounts of any type that are “severely past due.”⁴² Furthermore, PREPA has experienced unacceptable theft of

³⁶ Mary Williams Walsh, “Puerto Rico’s Power Authority Effectively Files for Bankruptcy,” NYTimes, July 2, 2017, available at <https://www.nytimes.com/2017/07/02/business/puerto-ricos-electric-power-authority-effectively-files-for-bankruptcy.html>.

³⁷ See Robert Slavin, “Judge Rejects PREPA receivership, citing Oversight Board’s power,” The Bond Buyer, Sept. 14, 2017, available at <https://www.bondbuyer.com/news/judge-rejects-prepa-receivership-citing-oversight-board-power>.

³⁸ 48 U.S.C. § 2174.

³⁹ Puerto Rico Electric Power Authority, New Fiscal Plan for PREPA: As Certified by the Financial Oversight and Management Board for Puerto Rico, April 19, 2018, available at <https://drive.google.com/file/d/1FgfYFjuuQTuH1nIQWY-xrEAWQxVdNPt/view>.

⁴⁰ Puerto Rico Act 57-2014, “Statement of Motives.”

⁴¹ FTI Capital Advisors, “Accounts Receivable and CILT Report,” at 9, available at <http://www.aeepr.com/Docs/restrukturacion/PREPA%20AR%20and%20CILT%20Report%20Final.pdf>.

⁴² AlixPartners, “Update on Transformation of PREPA, Presentation to the Governing Board,” Dec. 15 2015. See e.g. National Public Radio, Power Problems: Puerto Rico’s Electric Utility Faces Crippling Debt, May 7, 2015 (“The fearless 60-year-old now owes the power company nearly \$10,000 and has no intention of paying” . . . “Many in Puerto Rico share Vazquez’s dissatisfaction with the island’s state-owned power company”).

electricity produced, with reportedly 8% being stolen in 2010.⁴³ Failure to collect past due accounts and to prevent theft has greatly hindered PREPA's finances, and has promoted a culture in which electric customers do not necessarily believe they must pay for electric service.

The organizational structure of PREPA has promoted bureaucracy and politics over a meritocracy. Indeed, many "management and other strategic decisions . . . have been based on political considerations rather than best practices or sound business judgment."⁴⁴ For instance, each new Puerto Rican administration has "replaced about 200 of [PREPA's] top managers upon taking office" since 2001.⁴⁵ This has left the administrators of PREPA with weak management skills, and an inability to make quick decisions.⁴⁶ Due to this politicization, there has been no path to leadership within PREPA, which has encouraged an environment without individual accountability or goals.

Further demonstrating the poor working culture found within PREPA is the abysmal safety record. In the past 10 years, PREPA "has had 15 fatalities and approximately 14,000 safety incidents."⁴⁷ For a company of 6,800 employees, those statistics reflect an incident rate greater than two times per person employed.

Finally, PREPA provides financially untenable benefits to its employees. For instance, PREPA employees have approximately 50 days of paid leave each year and are the beneficiaries of the highest health benefit costs of all government entities in Puerto Rico. Furthermore, rigid pro-labor laws promote absenteeism of employees and low productivity.⁴⁸ These laws have continued unabated, and the sentiments underlying these benefits continue to be reflected by recent legislation. For instance, in the recent law signed by Gov. Rosselló seeking to privatize PREPA, Section 15 requires that all PREPA employees "retain their positions" or "be transferred to other positions within PREPA or other Government Entities."⁴⁹

Privatization should be the end goal that will achieve a successful conversion of PREPA; however, substantive structural and cultural reform within PREPA must occur – and given the hesitancy of the Puerto Rican government to advocate for transformational changes, it is unlikely that privatization will ever occur under the status quo.

⁴³ Standard & Poor's, "Global Credit Portal: Puerto Rico Electric Power Authority; Retail Electric," March 26, 2012, *available at*

[http://www.aeepr.com/INVESTORS/DOCS/Financial%20Information/Rating%20Report/getPDFdo%20articlePDF%20\(2\).pdf](http://www.aeepr.com/INVESTORS/DOCS/Financial%20Information/Rating%20Report/getPDFdo%20articlePDF%20(2).pdf).

⁴⁴ Lisa Donahue, Statement before the Puerto Rican Senate, April 14, 2015.

⁴⁵ Alex Nussbaum, "Oil, Politics Pave Path Toward Default in Puerto Rico," Bloomberg, May 12, 2015 (citing Lisa Donahue before the Puerto Rican Senate).

⁴⁶ AlixPartners, "Update on Transformation of PREPA, Presentation to the Governing Board," Dec. 15 2015.

⁴⁷ Lisa Donahue, Testimony in Support of PREPA Revitalization Act before the Puerto Rico House of Representatives, Nov. 11, 2015.

⁴⁸ AlixPartners, "Update on Transformation of PREPA, Presentation to the Governing Board," Dec. 15 2015.

⁴⁹ Puerto Rico House of Representatives House Bill no. 1481.